No. 12079

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Wilshire & Western Sandwiches, Inc., a corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

BRIEF OF PETITIONER.

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES.

Swarts, Tannenbaum, Ziffren & Steinberg and Jacob Shearer,

Attorneys for Petitioner.

David Tannenbaum,
Jacob Shearer,
Mitchell Aaronson,

Of Counsel,

650 South Spring Street,
Los Angeles 14, California.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

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WILSHIRE & WESTERN SANDWICHES, INC., a corporation,
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF PETITIONER.

JURISDICTION.

This is an appeal from a judgment of the Tax Court of the United States entered June 29, 1948.

Within ninety days after January 31, 1946, the date of the mailing by the Commissioner of Internal Revenue of a notice of a deficiency in the petitioner's income tax, excess profits tax and declared value excess profits tax [R. pp. 8-22] the petitioner filed its Petition for Redetermination of the deficiency pursuant to Section 272(a) of the Internal Revenue Code [R. pp. 4-7]. The Tax Court of the United States has jurisdiction of such an action under the provisions of Sections 1101 and 272 of the Internal Revenue Code.

As set forth in the Petition for Review [R. pp. 42-46], the petitioner is a resident of Los Angeles County in the State of California and its address is 3180 West Sixth Street, Los Angeles 5, California [R. p. 42]. The peti-

tioner filed its income tax, excess profits tax and declared value excess profits tax returns for the taxable years 1942 and 1943 with the Collector of Internal Revenue for the Sixth District of California whose office is located within the Ninth Judicial District wherein the petitioner also resides. [R. pp. 42-43.] The United States Court of Appeals for the Ninth Circuit has jurisdiction to review the decision of the Tax Court under the provisions of Section 1141 of the Internal Revenue Code.

STATEMENT OF THE CASE.

The petitioner was incorporated on March 24, 1941, under the laws of the State of California for the purpose of engaging in the drive-in restaurant business. [F. of F., R. p. 27.] The corporation has an authorized capital stock of 7,500 shares at $10.00 par value each. [F. of F., R. p. 27.] It kept its books and prepared its returns on the accrual basis. [F. of F., R. p. 28.] There was uncertainty at the time of incorporation as to the amount of money which would be needed by petitioner to erect the building in its business and to purchase the necessary equipment therefor, although it was estimated by three of the four incorporators of the petitioner that $30,000.00 would probably be adequate for this purpose. [F. of F., R. pp. 28-29.] The incorporators agreed to advance amounts sufficient to open the petitioner for business and to obtain in return stock certificates of the petitioner for approximately 50% of their advances and promissory notes bearing 6% interest and payable in two years from date of issue for the remainder. [F. of F., R. pp. 28-29.]

The cost of the building and equipment proved to be far in excess of the incorporators' estimates and in order to meet the expenses, advances totaling $55,000.00 were

made by the incorporators over the period from May to November, 1941. [F. of F., R. pp. 30-31.] The drive-in was completed and open for business on or about November 5, 1941. [F. of F., R. p. 30.]

At a meeting of the Board of Directors of the petitioner held November 13, 1941, a resolution was adopted authorizing the corporation to deliver to the incorporators promissory notes totaling $25,000.00 maturing in two years with interest at the rate of 6% per annum payable quarterly and 3,000 shares of $10.00 par value stock. [F. of F., R. p. 32.] The incorporators, H. B. Carpenter and M. A. McDonnell each received 1,000 shares of stock and notes in the amount of $8,333.34 and $8,333.33 respectively. William Simon and Mike Lyman each received 500 shares of stock and notes in the amount of $4,166.67 and $4,166.66 respectively. [F. of F., R. p. 32.]

Because of an oversight on the part of petitioner's accountant and bookkeeper, the notes were not entered on the books of the corporation until April of 1942, about four months after the notes were executed and delivered when another accountant was employed by the petitioner. [F. of F., R. p. 34.] The correcting entries were made immediately. [F. of F., R. pp. 34-35.] For the same reason, no interest, which according to the terms of the notes was to be paid quarterly, was accrued on the books of the corporation until early in 1943. [F. of F., R. p. 35.] Thereafter interest was accrued on the notes monthly. [F. of F., R. p. 35.] On December 1, 1943, $3,055.86 was paid to the noteholders as interest to November 30, 1943, and like payments totaling $682.10 were paid on March 23, 1945. [F. of F., R. p. 33.] The principal amount of the notes was paid in full by payments of $10,000.00 each on April 21, 1943, and May 23, 1944,

and $5,000.00 on March 23, 1945. [F. of F., R. p. 33.] All payments to holders of the notes were made in proportion to their holding of all of the notes. [F. of F., R. p. 33.]

In its returns for 1942 and 1943, the petitioner claimed $1,500.00 and $1,443.26 respectively as deductions for interest pursuant to the provisions of Section 23(b) of the Internal Revenue Code, on the notes which had been given to its incorporators. [F. of F., R. p. 35.] The Commissioner disallowed the deductions and determined deficiencies of $599.87 and $782.72 in the petitioner's income taxes for the years 1942 and 1943 respectively and determined deficiencies of $1,797.05 in the petitioner's excess profits taxes and $168.31 in the petitioner's declared value excess profits taxes for the year 1943. [R. pp. 8-22.]

On January 31, 1946, the Commissioner sent to the petitioner by registered mail a notice of the aforementioned deficiencies. [R. pp. 8-22.] Within ninety days thereof petitioner filed a Petition for Redetermination of the deficiency with the Tax Court of the United States [R. pp. 4-22], and on December 3, 4 and 12, 1947, a hearing was had before the said Tax Court. [R. p. 2.] On June 29, 1948, the Honorable Richard Disney, Judge, entered a Memorandum of Findings of Fact and Opinion wherein it was held that the amounts paid by the petitioner as interest on the notes held by its shareholders was not deductible by the petitioner as interest on an indebtedness in computing its net income subject to taxation. [R. pp. 27-41.]

The sole question presented on this appeal is whether or not the amounts payable by the petitioner in the years 1942 and 1943 to the holders of its notes was "interest

on an indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code and consequently deductible by the petitioner in computing its net income subject to taxation.

SPECIFICATIONS OF ERRORS.

1. The Tax Court erred in holding that the sum of fifteen hundred dollars ($1,500.00) accrued in the year 1942 and of one thousand four hundred forty three dollars and twenty six cents ($1,443.26) accrued in the year 1943 and paid by the taxpayer as interest on loans by its shareholders, was not deductible as interest on an indebtedness.

2. The Tax Court erred in refusing to hold that said sums mentioned above were interest on an indebtedness and as such were deductible from the taxpayer's gross income in determining its net income subject to taxation.

3. The Tax Court erred in determining that there was a deficiency in the taxpayer's income taxes for the taxable years 1942 and 1943.

4. The Tax Court erred in determining that there was a deficiency in the taxpayer's excess profits tax for the taxable year 1943.

5. The Tax Court erred in determining that there was a deficiency in the taxpayer's declared value excess profits taxes for the year 1943.

6. The Tax Court erred in making the following findings of fact which findings are not supported by the evidence:

a. "The incorporators of petitioner made the following payments, totaling $55,000, to petitioner in 1941 under the plan previously adopted by them.

	McDonnell	Simon	Lyman	Carpenter
May	$ 3,333.33			
June		$1,666.67	$1,666.66	$3,333.34
August		2,500.00	2,500.00	
September	5,000.00			5,000.00
October		2,500.00	2,500.00	
Nov. 13		2,500.00	2,500.00	
Nov. 19	10,000.00			5,000.00"

[R. p. 30.]

The $5,000.00 payments by Carpenter which the court finds to have been made in September and on November 19, 1941, were in fact made on October 30, 1941, and November 13, 1941.

b. "Simon expected the notes to be paid out of current earnings . . ." [F. of F., R. p. 32.]

The record clearly shows that Simon expected the notes to be paid in any event.

SUMMARY OF THE ARGUMENT.

I. Introductory.

The sole point of disagreement is whether the notes issued by the petitioner constitute an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. This in turn depends upon the intent of the parties involved.

II. Findings of Fact.

A. The formal findings of fact made by the trial court are correct with two exceptions. The two excepted findings are unsupported by the evidence.

B. The Tax Court's conclusion of law is inconsistent with its findings of fact because the findings competently made compel the conclusion that the interest herein involved is deductible in computing the petitioner's net income subject to tax. The court expressly found all of the elements necessary to constitute an indebtedness, to wit: an intent to loan and a meeting of the minds, a transfer of the consideration and a promise to repay evidenced by negotiable promissory notes.

III.

An analysis of the court's opinion and that factors considered therein demonstrates that there is no basis in law or in fact for the decision of the Tax Court denying the petitioner the deduction for interest accrued in the taxable years involved.

There is no rule of law which excludes from the scope of Section 23(b) of the Internal Revenue Code an indebtedness created under the circumstances existing in the case at bar, nor do such circumstances justify an inference that the notes executed and delivered by petitioner were not genuine.

IV.

Should this court be of the opinion that the Tax Court drew the ultimate inference which supports its decision, it nevertheless remains free to draw those ultimate inferences and conclusions which in its opinion the findings of the Tax Court reasonably induce.

ARGUMENT.

I.

Introductory.

The single issue in this case is whether petitioner was entitled to a deduction for interest in the years involved. The sole point of disagreement between the parties is whether the notes issued to petitioner's stockholders constituted an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code or whether they constituted investments in and contributions to capital. No question is raised as to the amounts involved or the proper accrual of interest if an indebtedness existed.

"Indebtedness," under the Revenue Act has been defined as an "unconditional and legally enforceable obligation for the payment of money." (*Autenreith v. Commissioner,* 115 F. (2d) 856 at 858 (C. C. A. 3rd 1940); see also *Commissioner v. Park,* 113 F. (2d) 352 (C. C. A. 3rd 1940); *Gilman v. Commissioner,* 53 F. (2d) 47 (C. C. A. 8th 1931).)

The question then resolves itself to a simple question of fact: Was there an unconditional and legally enforceable obligation for the payment of money on the part of the taxpayer in favor of the incorporators? If there was, the moneys accrued and paid for the use of the principal moneys are clearly deductible. (*Deputy v. du Pont,* 308 U. S. 488, 84 L. Ed. 416 (1940); *Old Colony Railroad Co. v. Commissioner,* 284 U. S. 552, 76 L. Ed. 484 (1932).) Or stated another way, were the promissory notes issued to the incorporators genuine, evidencing legal obligations of the petitioner? (*Toledo Blade Co.,* 11 T. C. 128 (1948).)

Whether or not there was an unconditional and legally enforceable obligation for the payment of money by peti-

tioner to the individuals depends solely upon the intent of the parties involved. (*Van Clief v. Helvering,* 135 F. 2d 254 (App. D. C. 1943); *Edward Katzinger Co.,* 44 B. T. A. 533 (1941); see also *Daniel Gimbel,* 36 B. T. A. 539 (1937); *Bernuth-Lembcke Co.,* 17 B. T. A. 599 (1929); *William D. P. Jarvis,* 43 B. T. A. 439 (1941), affirmed 123 F. (2d) 742 (C. C. A. 4th 1942).)

In the *Van Clief* case, *supra,* the taxpayer was the sole stockholder of a corporation and the issue was whether or not he was entitled to a loss by reason of the fact that the stock had become worthless in the taxable year 1937. This in turn depended upon whether or not advances by the stockholder of approximately $97,000.00 constituted loans to the corporation or capital contributions. If these advances were held to be loans, the corporate liabilities at the close of the taxable year in question exceeded the fair market value of the corporate assets, indicating, as the court pointed out, that the stock was worthless. The Board of Tax Appeals held that the advances constituted capital contributions and in reversing the judgment of the board, the Circuit Court of Appeals resolved the question to one of intent, in adopting, at page 256, the following language of the *Katzinger* case, *supra:*

> "Advances are an additional contribution of capital if they are intended to enlarge the stock investment but not if they are intended as a loan . . . Here the parties intended the advances as loans."

It follows then that once the intent of the parties here involved is determined no difficulty remains as to the proper conclusion. If the parties genuinely intended to make loans, the interest in question is deductible; if rather they intended to make capital contributions no deduction for interest is permissible.

II.

Findings of Fact.

A. The formal Findings of Fact Made by the Trial Court Are Correct With Two Exceptions. The Two Excepted Findings Are Unsupported by the Evidence.

The trial court made findings of fact, and, with two important exceptions, petitioner is prepared to accept the correctness but not the materiality of the formal findings of fact labeled as such by the court, but not necessarily of facts recited in the opinion or of the conclusion reached by the court. As to these two exceptions, there is no evidence to support the facts as formally found but on the contrary, in each case, ample uncontradicted evidence to require a contrary finding.

The first such exception relates to the alleged payment of $5,000.00 by Carpenter on November 19, 1941. [F. of F., R. p. 30.]

The second such exception relates to the finding [F. of F., R. pp. 32-33] that Simon *expected* the notes to be paid out of current earnings. (Italics ours.)

As to the first exception, the stipulation of facts [R. p. 258], made a part of the Tax Court's findings by reference, shows such payment was in fact made on November 13, 1941.

As to the second such exception, the only evidence relating to Simon's expectancy or thoughts concerning repayment appears at pages 65-66, 72 and 84-86 of the Record. In the first instance, in referring to the note, Simon testified that it was to be paid back as a loan. [Tr., R. p. 65.] No suggestion is there made of earnings or lack of earnings. In the second relevant portion of his testimony, he stated unequivocally that he expected the

note would be repaid and that he thought repayment would be made within two years. Here again, there is no suggestion of earnings or lack of earnings. The third discussion took place on cross-examination. [Tr., R. pp. 84-86.] In response to a question as to why he took promissory notes for part of his advances to petitioner, Simon pointed out, among other reasons, that, "I could get my money back faster even if the place wasn't a success. I didn't have to wait for dividends to be earned to get my money back that way [that is by way of a loan] I could get it back out of depreciation." Then followed a colloquy in which the witness Simon attempted to explain to respondent's counsel how he could get his loan repaid out of "depreciation" even if petitioner had no profits. [Tr., R. pp. 83-86.]

> "Q. Now, Mr. Simon, the stipulation shows that between June 9, 1941, and November 13, 1941, that you and Mr. Lyman had advanced certain money to the corporation. Now, will you please explain to the Court why it is that in return for the money advanced by you you took capital stock for only half the amount and instruments in the form of promissory notes for the other half?
>
> A. At the start of this particular proposition, when we had an informal meeting, it was agreed at that time that we would invest 50 per cent and take 50 per cent in notes as loans. As I testified earlier, I didn't want to freeze too much money in that particular unit. I had other commitments and I didn't want to come in there just as a stockholder, I wanted to come in there partially as a stockholder and partially as a creditor. One, I could get my money back faster even if the place wasn't a success. I didn't have to wait for dividends to be earned to get my

money back that way. I could get it back out of the depreciation.

No. 2, if the place would fail, I became a common creditor.

Q. What do you mean by getting your money out of depreciation?

A. As a loan, when it was set up as a loan, the place didn't have to make a loan—money to meet the loan every month and they depreciate the place over a 10-year period. If the place didn't make money there was enough money from depreciation to pay back those loans.

Q. Do you mean the company set up a cash reserve each month for depreciation?

A. Every corporation depreciates their investment.

Q. Did this corporation actually set aside and earmark cash money for depreciation?

A. According to the law, as I understand it, the tax law, you can depreciate 90 per cent of your investment to be depreciated over a period of 10 years. If you have a 10-year lease you can depreciate it over a period of 10 years. You can depreciate that monthly.

Q. How was that going to return your cash money to you, is what I don't understand, Mr. Simon.

A. Well, as the investment is depreciated that money accumulates.

Q. How did you expect to be repaid for these loans, except out of the current earnings of the business?

A. You don't have to have current earnings to be paid back on a loan.

Q. How would the corporation pay you back on the loan if it did not make any money?

A. You have a depreciation account they could use. You are depreciating your investment.

Q. What was the cost of the building? I believe the stipulation shows that. $40,489.68. Suppose the corporation didn't make sufficient money to set up a depreciation reserve, how then did you expect to get the return of cash money from your loan?

A. You mean if they lost money?

Q. Yes.

A. If they lost beyond their depreciation account, well, I would just have to come in as a creditor.

Q. In other words, this corporation, you had to realize this corporation had to make money before you could expect the payment back of your loan?

A. No, I didn't realize that. I don't know that. I don't think that is a bit necessary.

Q. Well, suppose the corporation hadn't made any money.

A. And if they didn't lose any money?

Q. Suppose they didn't make any money and actually lost money.

A. Well, that would be too bad. I would lose my money.

Q. In other words, you knew that your loan was just as good as the company's ability to make money, is that right?

A. That is right."

It will be observed that throughout this testimony Simon repeats over and over again his disbelief of the fact that it was necessary that the corporation earn a *profit* before it could repay his loan. Finally came the, "that is right" answer. It is startling enough that neither respondent's counsel, nor apparently the trial court, could recognize the correctness of the witness' contention that a corporation need not make a profit to repay its debts. Petitioner sub-

mits that it is actually fantastic that, upon the basis of the above quoted testimony, anyone could conclude as a matter of fact that Simon believed, whether rightly or wrongly, that it was necessary for petitioner to earn a net profit before his loan could be repaid.

This question of finding of fact relates solely to Simon's intent, and since the only other evidence relating to his intent was simply repetitive, it is submitted that the court erred in finding that Simon's intent was to look only to the current earnings of petitioner. The court had no alternative but to find that Simon's intent was to be repaid, even if petitioner had no earnings. In *Foran v. Commissioner,* 165 F. (2d) 705 (C. C. A. 5th 1948), the issue was the intent of the taxpayer in respect to certain property, that is, whether he intended to hold the property for reinvestment or for sale. The taxpayer's testimony as to his intent was the only evidence before the court and the Tax Court held that the properties in controversy were held for sale by the taxpayer. In reversing the decision of the Tax Court, the Circuit Court, distinguishing *Greene v. Commissioner,* 141 F. (2d) 645 (C. C. A. 5th 1944), pointed out at page 707 that:

> "Here there is direct and positive evidence from the witness who best knows, that this property was for eighteen months being held as an investment and not held for sale to customers. His testimony is consistent with every proven fact. He gives a credible reason why it was not for sale and why finally in 1941 he didn't sell it. We think the court's refusal to follow the sworn testimony is contrary to law and requires the setting aside of its fact finding as it would that of a jury,"

citing *Pennsylvania Railroad Co. v. Chamberlain,* 288 U. S. 333, 77 L. Ed. 819 (1933) at page 340. Here the tes-

timony of Simon is not only consistent with every proven fact but is further consistent with the rule of law, of which he was patently aware, that a creditor may look to a debtor's assets for repayment, without regard to current earnings of the debtor.

B. The Tax Court's Conclusion of Law Is Inconsistent With Its Findings of Fact Because the Findings Competently Made Compel the Conclusion That the Interest Herein Involved Is Deductible in Computing the Petitioner's Net Income Subject to Tax.

The facts as found, with the two exceptions specified, not only compel the conclusion that an indebtedness existed, evidenced by genuine promissory notes, but actually expresses that conclusion. In its findings of fact, the Trial Court enumerated many facts incidental to the background of petitioner and to its financing but made but four findings of fact which themselves expressed the actual existence or non-existence of an indebtedness. These four findings are as follows:

> 1. "The original intention was to make advances totaling $30,000.00 for stock and *loans* on an equal basis." [F. of F., R. p. 28.] (Italics ours.)
>
> 2. "The incorporators of petitioner made the following payments, totaling $55,000.00 to petitioner in 1941 *under the plan previously adopted by them.*

	McDonnell	Simon	Lyman	Carpenter
May	$ 3,333.33	$	$	$
June		1,666.67	1,666.66	3,333.34
August		2,500.00	2,500.00	
September	5,000.00			
October 30		2,500.00	2,500.00	5,000.00
*November 13		2,500.00	2,500.00	5,000.00
November 19	10,000.00			"

*Corrected pursuant to stipulation.

"At the time the advances prior to November were made, the individuals *intended* that stock would be issued for one-half thereof and *notes for the remainder.*" [F. of F., R. p. 30.] (Italics ours.)

3. "At a meeting of the Board of Directors of petitioner, the membership of which included the four incorporators, on November 13, 1941, a resolution was adopted, in accordance with an agreement reached at an informal meeting the previous day, to issue to the incorporators for advances made by them promissory notes, totaling $25,000, maturing in two years with interest at the rate of six per cent 6% per annum, payable quarterly, and stock totaling $30,000, as follows:

	Carpenter	McDonnell	Simon	Lyman
Stock	$10,000.00	$10,000.00	$5,000.00	$5,000.00
Notes	8,333.34	8,333.33	4,166.67	4,166.66"

[F. of F., R. p. 32.]

4. "The stock and notes authorized by the resolution were issued under date of November 13, 1941, and were delivered by December 5, 1941. In case of default in the payment of interest, the notes were to be immediately due and payable at the option of the holder." [F. of F., R. p. 32.]

Although other findings of fact related to the reasons the creditors made their loan, the circumstances under which they made it, the payment thereof and other facts incidental to the loans, the foregoing, without more, represents the complete lending transaction. This was comprised of:

First—the original executory contract to loan one-half of $30,000.00;

Second—pursuant to that contract, the actual loan of $15,000.00 plus an additional loan of $12,500.00;

Third—the agreement to take payment of $2,500.00 of the loans in stock; and

Fourth—the authorization, execution and delivery of the promissory notes evidencing the balance of the indebtedness of $25,000.00 created by the performance of the lenders pursuant to their contract to lend.

The weight of the evidence justifies and requires the court's conclusion and description of the ultimate transaction, as immediately above set forth. The witness, Simon, stated unequivocally that it was his intent to lend the corporation $4,166.67 [Tr., R. pp. 65, 66], and enumerated at some length the reasons that he and his brother, Lyman, insisted upon lending a portion of the advances to the corporation as distinguished from purchasing stock in the full amount of their advances. He wanted to hedge upon his investment by coming in as a common creditor in the event the corporation became insolvent [Tr., R. p. 61]; because of other money commitments which he had, he did not wish to freeze all of his available funds in one unit [Tr., R. pp. 64, 84]; he had in mind that even if the company did not make a profit, he might still receive repayment of his loan out of depreciation [Tr., R. p. 64] and because he and his brother were minority stockholders, he did not wish to depend upon the other stockholders for the declaration of a dividend [Tr., R. pp. 64, 84] but rather wished to be in a position where he had the right to demand repayment.

The witness, Carpenter, testified that he considered himself a lender to the corporation. [Tr., R. p. 122.] He gave as his reasons for making a loan his desire to come in as a creditor for part of the advances in the event the business failed [Tr., R. p. 121] and his desire to be in a position to demand repayment of the loan because he

was a minority stockholder and did not wish to be in a position where he had to rely upon the others for a dividend. [Tr., R. p. 122.]

Both of these witnesses testified concerning an informal meeting wherein they and the other stockholders agreed to lend one-half of the funds which might be necessary to be paid in to the corporation [Tr., R. pp. 63, 120] although the several stockholders had different estimates of how much would ultimately be necessary to advance. [Tr., R. p. 119.] The individuals advised their attorney of their intent to make loans to petitioner as well as to purchase its stock. [Dep., R. p. 251.] They further expressed that intent to the Commission of Corporations of the State of California in petitioner's application for a permit to issue its stock in which it advised said Commissioner of its proposal to sell $15,000.00 worth of shares to the incorporators, to borrow additional monies from said individuals and if necessary, to sell additional stock to said individuals. [Ex. 4-D, R. p. 301.] Nothing appears in the record of sufficient force to impeach this sworn testimony of the parties as to their intention in making the advances. To this the findings of the court set forth above attest.

The court having thus found that the petitioner had issued and delivered genuine promissory notes evidencing its indebtedness, it follows that interest paid or accrued upon that indebtedness is deductible under the provisions of Section 23(b) of the Internal Revenue Code.

III.

An Analysis of the Court's Opinion and the Factors Considered Therein Demonstrates That There Is No Basis in Law or in Fact for the Decision of the Tax Court Denying the Petitioner a Deduction for Interest Accrued in the Taxable Years Involved.

In its opinion, as distinguished from its findings of fact, the trial court gave several reasons justifying its conclusions that the interest herein involved is not interest upon an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code. The Tax Court's conclusion can only have been reached by the application of a rule or rules of law to the facts as found or by drawing inferences from such facts to reach an ultimate conclusion of fact that loans had not been intended.

The court did not, of course, expressly make such an ultimate conclusion of fact. Had it done so, there would have been two inconsistent findings, for such a conclusion is inconsistent with the finding of fact, expressly made, that the parties did intend to make loans. For the purpose of analyzing the opinion itself, however, this inconsistency will be disregarded in order to ascertain whether, in any event, such a conclusion has support in the record or may be justifiably inferred. It is submitted that there is no rule or rules of law which, applied to the facts, compel or justify the Tax Court's decision. Nor does any fact or group of facts found by the Tax Court justify drawing an inference that the parties did not intend to make loans. Petitioner proposes to examine factors

looked to by the trial court in its opinion to determine whether any rule of law exists which, if applied to one or more of such facts, will result in reaching the Tax Court's conclusion, and to determine whether in the face of overwhelming evidence to the contrary any of these facts give rise to a justifiable inference that loans were not intended by the parties.

These factors are as follows:

1. The proportion regarded as a loan by each stockholder was in direct proportion to his stockholding. [Op., R. p. 37.]

2. "The general plan was decided on prior to any business activity of petitioner and was intended to meet capital outlays which are usually paid out of invested capital and/or secured indebtedness." [Op., R. p. 36.]

3. The absence of evidence that the incorporators were lenders of money. [Op., R. pp. 36, 37.]

4. The assertion that "the advances here have few of the usual characteristics of commercial loans entered into in arms length transactions." [Op., R. p. 37.]

5. The asserted expectation of the parties with respect to the payment at maturity. [Op., R. p. 39.]

6. The treatment of the notes on the books. [Op., R. pp. 38, 39.]

They will be examined in the order petitioner considers logical, without regard to the order of their discussion in the opinion.

1. The Proportion Regarded as a Loan by Each Stockholder Was in Direct Proportion to His Stockholding. [Op., R. pp. 37, 39.]

(a) As a Rule of Law.

Though an indebtedness be owed by a corporation to its creditors-stockholders in proportion to their stockholding, it is nevertheless an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code and interest payable thereon is an allowable deduction from gross income. (*John Kelly Co.,* I. T. C. 457, affirmed 326 U. S. 521, 87 L. Ed. 278 (1946); *Commissioner v. O. P. P. Holding Corporation,* 76 F. (2d) 11 (C. C. A. 2d, 1935); *Toledo Blade Co., supra,* 11 T. C. 128; *Cleveland Adolph Mayer Realty Corp.,* 6 T. C. 730 (1946) (reversed in part on other grounds 160 F. (2d) 1012 (C. C. A. 6th, 1947)); *Clyde Bacon, Inc.,* 4 T. C. 1107 (1945).)

In the case of *Janeway v. Commissioner,* 2 T. C. 197 (1943), the Tax Court in its opinion (written by the author of the opinion in the instant case) used unfortunate language at page 202* which seemed to suggest that it was asserting a contrary rule of law. This language seems to state that as a matter of law, if the effect of both the lending and investing transactions are to give to the creditors, in their capacity of stockholders, proprietary interest in proportion to their loans, then the loans must be treated as stock investments regardless of intent. If the Tax Court, in that case, intended to express such a rule of law, its conclusion was rejected by the Supreme Court in *John Kelly Co. v. Commissioner,* 326 U. S. 521, 90 L. Ed. 278 (1946) and by the Tax Court itself in *Toledo Blade Co., Cleveland Adolph Mayer Realty Corp.* and

*See Appendix.

Clyde Bacon, Inc. cases, *supra,* where the loans were all recognized as loans in spite of the proportionate proprietary interests.

(b) As a Question of Fact.

The proportionate stock holdings and the lack of need to acquire additional proprietary interests do not justify an inference that the notes in question were not genuine. In the *Toledo Blade* case, *supra,* where one stockholder owned all of the stock of the taxpayer, the full Tax Court, without dissent, summarily disposed of the Commissioner's contention that the transaction was a sham, a contention that could have rested only upon an inference drawn from the circumstance that there was but a single stockholder.

The facts involved in the present case are considerably stronger for the taxpayer. There, at the time of the issuance of the debentures, the capital represented by the debentures was already invested in the business, and for the most part invested in fixed assets which could not be readily extricated from the risks of the business. No apparent business purpose was shown for the conversion of stock into debentures but the court pointedly refused to draw any inferences from that factor. In the instant case, several credible business reasons were present in the minds of persons before they advanced their funds and at a time when they were entirely free to enter into such contract as they chose, or for that matter to refuse to enter into any contract unless entirely satisfactory to them. Yet the *Toledo* decision rendered several months after its decision in the instant case was reviewed by and reflected the opinion of the entire tax court, without a dissent on this issue.

Nor did the tax court attempt to draw any such inference in the *Cleveland Adolph Mayer* case, *supra.* There again, the facts were much more open to such an inference than in the instant case. There as here the stock was originally owned (and there as well in the tax year in question) in proportion to the ownership of debentures. Reconversion took place so that there too the recipients of the debentures already had their money held by the corporation as capital stock. Moreover, as a result of the conversion the total capital stock issued was $600.00 as compared to debenture bonds in the sum of $210,000.00. Substantially, all of this $210,600.00 was represented by real estate and as in the *Toledo Blade* case was represented by assets less liquid than in the instant case. In addition, there was some problem as to whether or not the maturity date of the debentures could not be postponed by action of persons other than the holders thereof. Nevertheless, the court refused to draw the inference which the trial court here has apparently drawn.

Again in the *Clyde Bacon, Inc.* case, *supra,* the facts there are patently more susceptible of an inference such as drawn by the court in the instant case. There the taxpayer corporation was the successor of a corporation solely owned by the stockholders of the taxpayer corporation. In exchange for all of the stock of the predecessor corporation as well as other assets of the stockholders, all of which was alleged to have an actual value of $300,000.00, taxpayer corporation issued to the stockholders $30,000.00 worth of its capital stock and $270,000.00 of its debenture certificates all in proportion to the stock ownership of both the predecessor and the taxpayer corporations. The debentures provided that if the "cash position" of the taxpayer corporation did not warrant pay-

ment of interest, it might postpone such payment for four years, without the consent of the debenture holders. The rights of the debenture holders were subordinated to those of all creditors. Notwithstanding these factors, the court not only refused to draw an inference that the stockholders there did not intend to make a loan but on the contrary reconfirmed the right of the parties to enter into the contract, in the following language (at page 1116):

> "At the formation of the corporation there was no obligation on the petitioner to issue any definite amount of stock in exchange for the assets received. It had the privilege of determining the character and amounts of its securities so exchanged if they were satisfactory to the recipient. The petitioner had the right to replace the stock interest with an evidence of indebtedness, if it so desired."

That it does not follow that proportionate loans by stockholders is inconsistent with an intent to loan rather than to invest is apparent from *John Kelly Co. v. Commissioner, supra,* 326 U. S. 521, 90 L. Ed. 278 (1946). There Mr. Justice Reed, in pointing out the difference between "the wholly useless temporary compliance with the statutory literalness" involved in *Gregory v. Helvering,* 293 U. S. 465, 79 L. Ed. 596 (1935) and the two cases before it, refers to the "demonstrated possibility of sale by the holders of the obligations to persons other than stockholders . . ." as proof of the fact that even though the stock and the note were held in equal proportions by the shareholders, there is a substantial difference in their rights as shareholders and as creditors. It is interesting to note too that during the taxable years here involved, the stock of petitioner was not held in the exact

proportion of the loans of the individuals. As a matter of fact, in November or December of 1941, 100 shares of stock were transferred by Simon and Lyman to one Joe Lardemer [R. pp. 70-71, 242] who was never a creditor of the corporation. Thus the "demonstrated possibility" to which Mr. Justice Reed referred became an actuality in the instant case. When payments, whether by way of principal or interest, were made upon the notes, Mr. Lardemer did not participate. Thus not only can no inference be drawn, as was apparently done by trial court, but the facts from which the trial court attempted to draw such an inference were not correct.

2. **"The General Plan Was Decided on Prior to Any Business Activity of Petitioner and Was Intended to Meet Capital Outlays Which Are Usually Paid Out of Invested Capital and/or Secured Indebtedness." [Op., R. p. 36.]**

(a) As a Rule of Law.

Taxpayer knows of no rule of law which precludes a genuine indebtedness from being incurred for the purpose of obtaining a portion of the original sums necessary to commence business. See:

Bailey v. Clark, 88 U. S. (21 Wall.) 286, 22 L. Ed. 651 (1876).

(b) As a Question of Fact.

The factor here involved supports rather than discredits the *bona fides* of the plan. The interested parties could not conceivably foretell every development that might arise or predict to the last penny the amount of money which would be needed before the business could begin its operations. Accordingly, instead of contracting

to lend a specified amount and to purchase stock in a particular amount, they contracted by formula or percentages, a method frequently used in the conduct of business affairs. The court assumes that generally all monies used for what it calls capital "outlays" are usually paid out of invested capital or secured indebtedness or both. (*Cf. John Kelly Co. v. Commissioner, supra,* 326 U. S. 521, 90 L. Ed. 279 (1946); *Cleveland Adolph Mayer Co., supra,* 6 T. C. 730 (1946) and *Toledo Blade Co., supra,* 11 T. C. 128 (1948).) Petitioner submits that such an assumption is unwarranted. If it too is permitted to indulge in the use of "common knowledge" or what "usually" happens, petitioner suggests that the bulk of small business commenced in this country are commenced in part with ordinary unsecured bank loans.

Even granting *arguendo* the court's assumption is warranted, that fact nevertheless does not give rise to an inference that the parties did not intend to make genuine loans. True an inference that loans are intended might reasonably be drawn where parties insist upon and obtain security for loans made to a corporation to meet "capital outlay." The converse is not necessarily true and it would certainly be a *non sequitur* to say, as the court has in effect here said, that because such security is not obtained we may infer an intention to contribute to capital from the bare circumstances that the funds obtained are to be used to meet "capital outlay."

3. The Absence of Evidence That the Incorporators Were Lenders of Money. [Op., R. pp. 36-37.]

(a) As a Rule of Law.

It is not necessary that persons who loan money in specific instances be generally engaged in the business of lending money before the loans which they do make may be treated as indebtedness within the provisions of Section 23(b) of the Internal Revenue Code. In the *Toledo Blade Co.* case, *supra,* the lender was a corporation owning stock of newspaper corporations and there was no evidence in that case that that stockholder was a lender of money; nor did such evidence appear concerning the stockholders in the cases of *John Kelly Co., supra; Cleveland Adolph Mayer Realty Corp., supra,* or *Commissioner v. O. P. P. Holding Corporation, supra.*

(b) As a Question of Fact.

Presumably, the court refers to this factor upon the theory that had the incorporators been in the business of lending money, it would have been prepared to infer that any loan which they made was genuine. However, the court apparently is prepared to make a converse inference; that is, that since they were not in such a business it infers that any loan which they may have made is not genuine. Such a process of reasoning might be valid if it were a rarity for persons not in the business of lending money to make loans. But we need go no further than the Tax Court's own decisions relating to non-business bad debts to realize that non-business debts are created,

bona fide, every day and in numberless instances. As the court itself points out, these very stockholders loaned an additional $10,000.00 in February of 1942, and no suggestion was made that this was a capital contribution and not a loan. Neither the court nor respondent suggests that for excess profits tax purposes that amount should be treated as invested capital rather than borrowed capital. Yet there was no evidence between May, 1941, and February, 1942, that the stockholders had entered the business of being lenders of money.

4. The Assertion That "the Advances Here Have Few of the Usual Characteristics of Commercial Loans Entered into in Arms Length Transactions." [Op., R. p. 37.]

(a) As a Rule of Law.

The indebtedness referred to in Section 23(b) of the Internal Revenue Code does not distinguish between one with usual, as opposed to one with unusual characteristics. True it is, that regardless of the name given an instrument evidencing an obligation, if it has legal attributes of such a nature placing it without the legal definition of "indebtedness," such an obligation would not qualify as an indebtedness for the purposes of Section 23(b) or for any other purpose. (*Cf. 1432 Broadway Corporation,* 4 T. C. 1158 (1945).) But if there be an indebtedness within the meaning of that term as defined above, then interest paid or accrued thereon is deductible under the plain language of the statute. (*Cf. Old Colony Railroad Company v. Commissioner,* 284 U. S. 552, 76 L. Ed. 484 (1932).)

(b) As a Question of Fact.

It follows then that this alleged factor of unusualness can be material only for the purpose of imputing a lack of genuineness to the notes, which themselves were ordinary promissory notes in usual form. In justifying its statement concerning the unusual characteristics, the court looked to four attributes which it considered unusual. The first was that,

> "All of the amounts were paid in to provide petitioner with funds to start business, hence all of it was working capital." [Op., R. p. 37.]

The second so-called unusual attribute was asserted to be the fact that,

> "The amount of $55,000.00 was required to place the restaurant in condition to commence business, yet there was no agreement to advance the final $30,000.00 paid in until November 12, 1941, a week after the restaurant opened for business." [Op., R. p. 37.]

The third unusual attribute asserted by the court was the fact that,

> ". . . until then [November 12, 1941] no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans." [Op., R. p. 37.]

The fourth unusual attribute mentioned by the court was the fact that,

> ". . . no interest . . . was incurred by petitioner prior to November 13, 1941. In the meantime there was no agreement on when interest would start, the rate of interest or an agreement with petitioner on when the loans would mature. . . ." [Op., R. p. 38.]

The court in its opinion, does not assert what are all of the usual characteristics of commercial loans entered into in arm's length transactions. Petitioner submits, nowever, that as a matter of common knowledge, almost all, if not all of the usual characteristics of customary unsecured arm's length commercial loans are the following: the passing of money or credit from the lender to the borrower; the exaction by the lender from the borrower of a promise to repay; the fixing of a date certain for the repayment; the exaction of a promise from the borrower to pay interest to the lender; and the reduction of the borrower's promises to writing, frequently in the form of a promissory note or other negotiable instrument. All of the foregoing characteristics are present in this case.

It is apparent then that the court was not really concerned with the absence in this transaction of those essential characteristics which usually comprise all of the characteristics of a commercial loan, but was concerned rather with the additional presence of the four attributes quoted above. Accordingly, the problem in connection with the so-called unusual situation resolves itself to whether these four attributes, or any of them, justify an inference that the notes were a sham, and that the stockholders did not intend to lend money to petitioner.

As to the first attribute, that

> "All of the amounts were paid in to provide petitioner with funds to start business, hence all of it was working capital." [Op., R. p. 37.]

it should be observed that the court is really making two inferences. The unquestioned fact in the record is that the money was used to assist petitioner to start business.

The court first infers that this in itself is a departure from the normal. It then infers, because of the existence of such inferred departure, that the notes were not genuine and that the stockholders are not telling the truth when they expressed their intention to make a loan to petitioner.

Petitioner submits that neither inference is justified. There is of course no evidence in the record which even suggests that ordinary commercial loans are not frequently made to assist a debtor to start business. Therefore, in considering this attribute to be unusual the trial court is drawing upon what it believes to be a matter of common knowledge. Common knowledge of course is equally available to petitioner and to the Appellate Court. Petitioner submits that the trial court is in error in this regard and suggests that many commercial loans are made to borrowers to enable them to start business. In a free enterprise system, it is a strange philosophy indeed to suggest that only he who has sufficient money of his own to do so may embark upon a new business enterprise.

However, even if the making of such a loan to assist a lender to start business is itself unusual in ordinary commercial transactions, such unusualness does not justify the further inference, in the light of the circumstances existing here, that the testifying stockholders were lying or that the notes were not genuine. The court's essential error in this regard lies in the fact that he is testing the veracity of the incorporators expressed intent by standards which have no bearing upon the situation present here. Conscious though it be, for another purpose, of the individual creditors' status as stockholders, the court is apparently completely unmindful of that status for the purpose of determining whether or not they are

telling the truth when they say they intended to make loans. Instead, the court seems to ask itself: Would a bank lend something less than approximately one-half of the funds needed by this petitioner to commence business? It then answers that question in the negative and infers therefore that no lender of money would do so, regardless of the interest which another lender of money might have in the ultimate business success of the enterprise. If under such circumstances, an inference of sham may be drawn from the fact that a bank would not make an unsecured loan for the purpose present here, such an inference should have been compulsory in the *Toledo Blade* case, *supra,* 11 T. C. 128 (1948), where the loans represented six-sevenths of the amounts originally needed by the debtor there to start business and where the court itself admitted there was no apparent business purpose for a loan. Such an inference should have been compulsory in the *Cleveland Adolph Mayer* case, *supra,* 6 T. C. 730 (1946), where the proceeds of the loan represented almost 100% of the funds needed and used by the taxpayer there to start business. Such an inference should have been compulsory in the *Clyde Bacon, Inc.* case, *supra,* 4 T. C. 1107 (1945), where nine-tenths of the funds needed by the corporate taxpayer there to start business was advanced to it, without security, by its stockholders. It is patent that in those three cases the Tax Court recognized that persons who have a proprietary interest in a corporation are likely to be more willing than banks to make unsecured loans to the corporation to assist it to start business and that because such proprietary lenders are likely to be more lenient, no inference can be drawn from the mere fact that their actions may differ from a cautious bank's lending policy.

As to the second attribute troubling the court, that,

> "The amount of $55,000.00 was required to place the restaurant in the condition to commence business, yet there was no agreement to advance the final $30,000.00 paid in until November 12, 1941, a week after the restaurant opened for business." [Op., R. p. 37.]

it should be noted that by November 12, 1941, all but the final $20,000.00 rather than $30,000.00 had been paid in [Stip., par. 6, R. pp. 257, 258]. Of said balance of $20,000.00, McDonnell had definitely committed himself to pay $5,000.00 to bring his advances to a par with the other two groups, in line with the original agreement.

It may be true that there was no formal commitment on the part of the three groups to contribute the final $15,000.00 until November 12, 1941, but it is impossible to see why the lack thereof can support an inference that the testifying stockholders were lying when they testified that they intended to be loans to the petitioner, approximately one-half of the advances which they had made or to justify an inference that the notes were not genuine. As each advance prior to November was made, as the court expressly found, "the individuals intended that stock would be issued for one-half thereof, and notes for the remainder." [F. of F., R. p. 30.] If then, the individuals intended notes to be given to them in the amount of one-half of these advances, how could the absence of a formal commitment to make additional advances affect the intent as to the advances made before November. As to the remaining advances made in November, those were agreed upon by the individual stockholders on November 12, 1941 [F. of F., R. p. 32] and formally by petitioner

on November 13, 1941. [F. of F., R. p. 32 and Pet. Ex. 12.] That agreement called for the execution and delivery of notes, as well as for the issuance of stock. [F. of F., R. p. 30.] In other words the court finds expressly that of the $35,000.00 actually paid (and the additional $5,000.00 inferentially committed by McDonnell) prior to November the individuals intended to receive from petitioner notes for one-half thereof, or $20,000.00 and the court further finds that as to the $15,000.00 advanced in November there was an agreement upon a division between stock and notes. Yet the court seems to infer that in spite of this intent, which it finds to be present on each occasion that advances were made prior to November, there was no such intent at the time of such advance because there was no commitment to do anything further beyond the advance. Petitioner submits that a trial court may not make an express finding of fact based upon evidence that could call for no other finding and then, in its opinion, infer the falsity of that fact simply to justify its ultimate conclusion.

As to the third attribute, that,

> "Until then November 12, 1941 no final agreement was reached on the proportions of the advances to be regarded as loans and for the purchase of stock, or the terms of the loans." [Op., R. p. 37.]

it is difficult to understand why the court should be troubled with a lack of what it calls "a final" agreement and why because of that lack until November 12, 1941, it should infer that the notes issued pursuant to agreement could not have been genuine. This it is submitted is a complete *non sequitur*. Here again, for this purpose, the court seems to forget the interests of the lenders in peti-

tioner's business enterprise and rather sets up as a standard to test their veracity the requirements of a commercial bank. Moreover in drawing its inference that no loans were intended it seems to forget too that it expressly found as a fact that as to monies paid in prior to November 12, 1941, the parties intended to invest one-half in petitioner's stock and to lend one-half. What happened thereafter is readily understandable. On November 12th there was a further agreement that additional amounts would be paid into the company, making an overall total of $55,000.00, and it was further agreed that a total of $25,000.00 of this amount would be paid into the company as a loan. Pursuant to the original understanding and that arrived at on November 12th, such moneys were paid in and notes were issued in the total sum of $25,000.00. If any inference is to be drawn from these facts, petitioner submits that the inference must be that the notes were genuine since the execution and delivery of the notes were consistent with that agreement.

If the court is troubled by the fact that instead of conforming exactly to the original idea that full one-half of the moneys paid to the company was intended to be paid as loans, a somewhat lesser amount of notes were issued, that too is easily explainable. The only variation between the plan as originally adopted and as finally carried out was the agreement by the individuals to waive a small portion of their loans and to accept stock in lieu thereof. Whether this be deemed a variation or considered a positive payment of the loan by the issuance of stock is immaterial. The fact is that had they so chosen, the stockholders could have contributed to capital amounts in excess of that which they had committed to pay to the cor-

poration. However, while the corporation was free to receive, it was not free to give away, and under California law, could not agree to treat as a loan moneys which had been paid to it pursuant to a commitment to purchase stock. (Sec. 824 Corp. Code of the State of California.) It follows then that the parties were not, as the trial court suggested, "at all times in a position to divide the advances between stock and notes in any proportion." Their freedom was limited only to the increase of the stock purchased, if they so chose, or to the contribution to capital. They could not lawfully decide to increase the proportion of the loans and they did not do so.

Except as to this permissible variation, however, the conduct of the individuals was entirely consistent with the original plan. By July of 1941, they were already aware of the probability that the original estimate was too low and that the corporation would have to procure additional funds, but during the entire period, from April through November of 1942, the individuals continued to understand that approximately one-half of the advances which they were making were to be repaid as loans. They so stated to each other [R. pp. 23-24], to their attorneys [Dep., R. p. 251] and to the California Corporation Commissioner. [Ex. 4-D, R. p. 301.] That on November 12, 1941, they decided to let the corporation have a trifle more of invested capital than they had previously committed themselves to give to it cannot of itself require that they do the same with the balance of their loans. Nor should that fact have weight to persuade a court to conclude that the original April agreement and the intent of the individuals as each cash advance was made, the existence and terms of which the court found to be true in its formal findings of fact, did not actually exist.

As to the fourth attribute, that,

> ". . . no interest . . . was incurred by petitioner prior to November 13, 1941. In the meantime there was no agreement on when interest would start, the rate of interest or an agreement with petitioner on when the loans would mature. . . ." [Op., R. p. 38.]

it should be remembered that the court is referring to the advances made prior to November 13, 1941. These are the very advances which the court in its express findings of fact found to be made by the advancers with the intention "that stock would be issued for one-half thereof and notes for the remainder." [F. of F., R. p. 30.] This is another instance where the court in its opinion seeks to discard the fact actually found by it. The result is that because the parties made no express or written stipulation for the payment of interest and for a maturity date at the time they made the various advances which the court held to be genuine loans, the court infers that when they did make such stipulation for payment of interest and a maturity date by requiring and receiving promissory notes, the promissory notes were not genuine. This of course is an absurd result. The fact is that here again, for the purpose of judging the veracity of the testifying lenders, the court has completely disregarded their interest in the success of the business, a fact which for other purposes it has weighed so heavily against them.

5. The Asserted Expectation of the Parties With Respect to Payment at Maturity. [Op., R. p. 39.]

In its opinion [R. p. 39] the court states that the parties did not intend to assert the rights of a lender because they did not in all events expect repayment at maturity.

This statement is based upon the testimony of Simon (whose position the court properly assumes to be that of his brother) and of Carpenter. As the court points out, Simon "testified that he expected the note to be paid at maturity but would not have insisted upon payment if payment would result in financial hardship to petitioner." [Op., R. p. 39.] Carpenter testified that "he did not expect payment unless petitioner had funds." [Op., R. p. 39.] To judge whether the court is justified in jumping from Simon's possible leniency in an extreme situation to the conclusion that he did not intend to assert rights of a *bona fide* lender, reference is made to the testimony given on Simon's cross-examination, to which the opinion refers, as follows:

> "Q. . . . Was it your intention at the time this note was executed to demand payment of that note at its due date, regardless of the financial condition of the corporation at the time?
>
> A. That is right.
>
> Q. It was?
>
> A. Yes, sir.
>
> Q. Even though it meant the liquidation of the business?
>
> A. I don't suppose so. I would be very fair about it.
>
> Q. In other words you would not have insisted upon the payment of this note at its due date if it meant a financial hardship to the business?
>
> A. No, I don't suppose I would." [Tr., R. p. 90.]

It is clear from the foregoing, as well as from all of Simon's other testimony, that Simon was not discussing his right as a creditor but was merely speculating, at respondent's counsel's invitation, as to what he might do to

avoid bankruptcy if, at the time his loan matured, the corporation found itself hard pressed for funds. To convert the witness' speculation as to his probable leniency, if that seemed a wise thing to do, into an absence of the intent to make a loan is to ignore the actualities of business life. This is something that any creditor, in an appropriate situation, might do. To suggest that because any creditor, let alone one who also had a proprietary interest in the business, does not intend to assert his rights as a creditor because he may not, in case of default, in all events force the borrower into bankruptcy or liquidation is to say that very few of the loans made in business, even by banks are *bona fide* loans. As to Carpenter's speculation, it was, as the court points out, that he did not *expect* payment unless petitioner had funds. That, it is submitted, is true of any creditor's expectation as to payment and is clearly not of such significance as to cause the court to forget it had found that Carpenter had intended to make a loan and consequently had *intended* to be repaid.

6. The Treatment of the Notes on the Books. [Op., R. pp. 38-39.]

The bookkeeping entries are significant only insofar as they bear upon the factual issue of the intention of the parties making the advances. The petitioner readily admits that bookkeeping entries made with the knowledge of a principal or pursuant to his orders may validly be used as the basis for an inference as to the principal's intention with respect to the matter recorded. The fallacy in attempting to draw such an inference as to intention, where the person for whose intention we are seeking, had no actual knowledge of the entries made is readily apparent. Inferences as to intention may only be drawn from the

words and acts of the party whose intention is to be determined.

An examination of the uncontradicted testimony of the witnesses, Whittaker, Aye, Tompkins and Carpenter, makes clear that the bookkeeping entries in question in the case at bar were made wholly without the knowledge, authority or direction of any of the parties whose intention is in issue. Rather, the entries to which the trial court refers were a result of an error on the part of the accountant, Whittaker and the petitioner's bookkeeper.

Benjamin Whittaker, called as a witness by the respondent, testified that Carpenter came to his office in 1941 to request that Whittaker outline a set of records for Carpenter's bookkeeper to install and use. [Tr., R. p. 100.] In October of 1941, he received the minute book of the petitioner from Mr. Odell for use in preparing the outline of the books and the opening journal entry. [Tr., R. pp. 101-102.] He did not scrutinize the minutes closely but looked through them for anything that might affect the corporation's books. [Tr., R. p. 102.] At no time did he discuss with Carpenter the manner in which the advances by the stockholders were to be handled on the books. [Tr., R. p. 104.] After returning the minute book to Mr. Odell on October 23, 1941, he never saw any minutes which were later included in the minute book. [Tr., R. p. 105.]

It is important to note in this connection that the minutes as of the time they were examined by Whittaker in October of 1941 did not contain any information as to the ultimate agreement with respect to the amount of the advances theretofore made to be considered as investment in stock and as loans. That agreement was reached at a stockholders' meeting held on November 13, 1941. [Tr., R.

pp. 67-69; Pet. Ex. 12.] There was, therefore, a complete lack of any instructions as regards the handling of the notes on the books.

Carpenter testified that he knew nothing about the books of account [Tr., R. pp. 143, 156] or that they did not up to April, 1942, show any notes payable to stockholders. [Tr., R. p. 157.] The first time he became aware of such omission was December 3, 1947, the first day of the trial in this proceeding. [Tr., R. p. 158.] He did not realize that it was necessary that the notes be recorded on the books and had no knowledge of books or bookkeeping. As president of the corporation his interest in the books was limited to examinations to determine the cost of items purchased by the corporation. [Tr., R. p. 169.] His complete confidence in and reliance upon his accountant in the management of the accounting aspects of the business is evidenced by the fact that he signed the petitioner's 1941 income tax return without examining it. [Tr., R. pp. 110, 144.]

Elias J. Aye testified that in April or May of 1942, he was asked by William Simon and Mike Lyman, his clients, to look at the petitioner's books and inform them as to their contents. [Tr., R. p. 193.] Having been acquainted with Mr. Simon's business, he knew that Simon had taken notes from the petitioner. [Tr., R. p. 184.] His trial balance taken in April or May, 1942, disclosed that no notes were shown on the books. [Tr., R. p. 184.] He so reported to Simon and Carpenter and they agreed that the entries were wrong and directed him to make whatever correcting entries were necessary. [Tr., R. p. 184.] He then set up the notes and the capital stock, the way the stock had been issued in accordance with the permit from the Corporation Commissioner [Tr., R. pp.

185, 186], $30,000.00 capital stock and $25,000.00 notes payable. [Tr., R. p. 192.]

The impossibility of drawing an inference as to the intention of the parties from such a state of facts has already been demonstrated. The trial court itself found that the books *"erroneously* reflected the capital stock outstanding." (Italics ours.) Its treatment of this factor is another example of its failure to keep the issue before it clearly in mind at all times. With the issue clearly defined it could not but have realized the immateriality of the bookkeeping entries unless they were made with the knowledge of the parties whose intention is in issue.

The evidence relating to the recording of interest accruals on the books likewise demonstrates only the inexpert manner in which the books were kept. The testimony of Carpenter as to his complete lack of supervision and understanding of the books is equally applicable here to attest to the fact that the absence of these entries was also unknown to him. The proper entries were made by Mr. Tompkins only upon the direction of Mr. Aye after he had discovered the omission in preparing the corporation's income tax return for 1942. [Tr., R. p. 213.] The record at no point justifies charging the note holders with knowledge of the omission. Again the true state of the facts shows that this factor is in no way relevant to the issue of the intention of the parties making the advances. Upon the record as it stands, the treatment of the notes on the books has no significance in determining the intention of the parties.

IV.

Should This Court Be of the Opinion That the Tax Court Drew the Ultimate Inference Which Supports Its Decision It Nevertheless Remains Free to Draw Those Ultimate Inferences and Conclusions Which in Its Opinion the Findings of the Tax Court Reasonably Induce.

The scope of review of the decisions of the Tax Court of the United States by the Court of Appeals is no longer subject to the restriction imposed by *Dobson v. Commissioner of Internal Revenue,* 320 U. S. 489, 88 L. Ed. 248 (1943), since the amendment to I. R. C. Section 1141(a) which became effective September 1, 1948. The Courts of Appeal now having jurisdiction to review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Court in civil actions tried without a jury."

It has long been established that Circuit Courts will not set aside or disturb findings of fact of the District Court unless they are "clearly wrong," "unsupported by the evidence" or "unsupported by substantial evidence." (Rule 52(a) Federal Rules of Civil Procedure, 28 U. S. C. A. following Section 273(c), *Mente & Co. v. Isthmian S. S. Co.,* 122 F. (2d) 266 (C. C. A. 2d 1941); *Pressed Metals of America, Inc. v. Woodworth,* 119 F. (2d) 210 (C. C. A. 6th 1941).) But this rule has been restricted to situations in which the subjects of review are evidentiary or primary facts which the trial court has found upon hearing witnesses who appeared before it so that it was in a better position than the reviewing court to judge their

credibility as opposed to situations in which the question is one of drawing inferences from facts as found by the trial court. In the latter situation, the reviewing court is in as good a position to draw its own inferences or conclusions from the evidentiary facts as found by the trial court as is the trial court itself, since there is no question of credibility of witnesses involved.

The leading case setting forth the principle above stated is *Kuhn v. Princess Lida of Thurn & Taxis,* 119 F. (2d) 704 (C. C. A. 3d 1941). In that case, the plaintiff sued for reasonable attorneys' fees for professional services rendered to the defendant in connection with the review by the Board of Tax Appeals of a proposed deficiency assessment. The District Court found that $8500.00 was reasonable attorneys' fees considering all the facts of the case, including difficulty of legal problems involved, amount of time necessarily spent in litigation and other matters. The Circuit Court reversed and remanded with direction to enter judgment for $2500.00 in favor of the plaintiff. The court said that the conclusion as to the reasonable value of the services was an ultimate fact and so subject to complete review on appeal. As the court so aptly put it at pages 705-706:

> "the Rule does not operate, however, to entrench with like finality inferences or conclusions drawn by the trial court from its fact findings and so, while accepting the facts, competently found by the trial court as correct, an Appellate Court remains free to draw the ultimate inferences and conclusions which, in its opinion, the findings reasonably induce."

To the same effect is *Murray v. Noblesville Milling Co.,* 131 F. 2d 470 (C. C. A. 7th 1942), cert. den. 318 U. S. 775, 87 L. Ed. 1145 (1943), where there was a suit by

some 25 employees of the defendants for unpaid compensation under the Fair Labor Standards Act, Section 7(a). The issue was whether the plaintiff's employees had agreed to abrogation of the existing contract and had agreed to work for new rates rather than the rates established by the previous contract. The District Court having found all of the evidentiary or primary facts, found that the new contracts were not *bona fide* contracts of employment and were not intended to fix rates at which the employees were employed. The Circuit Court, citing the *Kuhn* case, *supra,* held that the contracts were *bona fide* contracts of employment and were intended to, and did fix the regular rate at which the employees were to be employed, and reversed the District Court to that extent. They stated that the question of the intention with which the parties entered into the contract was an ultimate fact and consequently, on the basis of the *Kuhn* case, *supra,* subject to complete review by the reviewing court. For further authority in support of this principle see *Adams County v. Northern Pacific Railway Co.,* 115 F. (2d) 768 (C. C. A. 9th 1940), where this court applied the same rule to findings of a special master and *Stubbs v. Fulton National Bank of Atlanta,* 146 F. (2d) 558 (C. C. A. 5th 1945), cert. den. 325 U. S. 864, 89 L. Ed. 1984 (1946).

As applied to the case at bar, the ultimate inference is, as we have set forth above, the inference as to the intention with which the parties made the advances to the petitioner. Inferences must be drawn from the relevant facts found by the Tax Court hereinbefore discussed which inferences this court is as competent to draw as the Tax Court. As we have said before, it is difficult if not impossible, to determine the basis for the Tax Court's decision in this case. Our interpretation of the decision is such that the Tax Court has found in our favor on this

issue. Should however, this court decide that the Tax Court did draw the inference which supports its decision, this court, sitting as a court of review, remains free to determine the intention of the parties from the primary facts competently found by the trial court without regard to whether or not there is support in the record for the inference drawn by the Tax Court. That, however, only one reasonable inference can be drawn in the premises, that is that the parties intended to make loans, is manifest from an examination of the evidence and the facts competently found by the Tax Court.

That such was the intention of Congress in enacting the amendment to I. R. C. Section 1141(a) is apparent from the committee report relating to this amendment. There the Senate Committee on the Judiciary stated that the language used in the house bill and adopted by the Senate had the effect of repealing the rule laid down in *Dobson v. Commissioner of Internal Revenue, supra,* "to the effect that decisions of the Tax Court on questions of fact, including questions of accounting and ultimate conclusions of fact, are not reviewable if supported by any evidence in the record." (Sen. Comm. on Jud., 80th Cong., 2d Sess. Report No. 1559, p. 131.) There we see the Senate Judiciary Committee drawing the distinction laid down in the *Kuhn* case, *supra,* as to questions of primary fact and ultimate conclusions of fact. Their very reference to that distinction makes it clear that it was the Congressional intent in enacting Section 1141(a) of the Internal Revenue Code to do away with the many times unfair result reached by applying the mandate of the *Dobson* case, *supra,* particularly as such mandate related to review of ultimate conclusions of fact and inferences drawn from findings of evidentiary fact. It was the intention of Congress that Courts of Appeals sitting in review of de-

cisions of the Tax Court of the United States should be free to reverse decisions of the Tax Court on questions of ultimate fact and inference drawn from primary facts without reference to whether or not the conclusion of the Tax Court had support in the record. It was the Congressional intention that by insuring that the most reasonable of two conflicting inferences would be chosen justice would be done to all litigants who choose to have their tax liability determined by the courts.

Conclusion.

Only one reasonable conclusion can be reached from the facts which exist in the case at bar—that a valid indebtedness of the petitioner existed, and therefore the interest which was accrued thereon in the taxable years here in question is deductible by the petitioner in computing its net income subject to the tax.

The decision of the Tax Court should, therefore, be reversed and judgment entered in favor of the petitioner allowing as a deduction the interest accrued in the taxable years 1942 and 1943.

Respectfully submitted,

Swarts, Tannenbaum, Ziffren & Steinberg and
Jacob Shearer,

Attorneys for Petitioner.

David Tannenbaum,
Jacob Shearer,
Mitchell Aaronson,

Of Counsel,

[illegible]

APPENDIX.

Internal Revenue Code Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

. . . (b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

Internal Revenue Code Sec. 1141. Courts of Review.

(a) Jurisdiction.—The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code.

California Corporations Code Sec. 824. Unlawful Purchase of Shares, Declaration or Payment of Dividends, or Withdrawal or Distribution of Assets. Except as provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

Excerpt From "Janeway v. Commissioner," 2 T. C. 197 (1943) at page 202:

"Our examination of this interesting question convinces us that the petitioners held securities under section 23(g) (2) and (3). The substance, and not the form of what was done, controls for the tax purpose here involved. Although the parties did set this matter up on the corporate records as one of issuing notes plus stock, and although the petitioners contend that the stock was a mere bonus in consideration of the loan of money to the corporation, in our view one salient fact requires a negative answer to such contention: All of the corporate stock issued in connection with the advancements of money was issued in direct proportion to the amount of money put out by the stockholders; that is to say, that for each $1,000 advanced by the two petitioners, by White and by Thomas, the other stockholders, each received six-tenths of a share of stock. The fact that for the last $1,000 advanced by each no stock was issued was, under the evidence, mere inadvertence. It was issued, as was all the other stock, under the resolution of March 8, 1934, providing for the issuance of the six-tenths share of stock for each $1,000. Considering the fact of such issuance in precise proportion to the amount of money advanced by the stockholders, we can not hold the stock, although issued in small quantities, to be a mere bonus, of no consequence to the present question; for the fact that the stock was issued in small quantities is immaterial, since the entire stock issue was only 22.8 shares.

"Not only are the petitioners not mere creditors, but also stockholders, but when they received the notes and stock they received pro rata control of the corporation through ownership of its stock in proportion to the amount of money advanced. Had the corporation earned large amounts of money, the petitioners would have been entitled to the whole thereof, that is, in accordance with their portion of the 22.8 shares of stock extant. In such a situation, we think we may not regard the stock as a mere bonus given because of the loan of money, as in substance the petitioners view the matter. The effect was that in return for the money and in exact proportion thereto, the petitioners and the other stockholders received a capital interest in and control of the corporation, and all of its assets, earnings, and profits. The effect would have been in nowise different had 1,000 shares issued for each $1,000 contributed, for the stockholders, including the petitioners, controlled the corporation just as effectively with 22.8 shares of stock as they would have with several thousand shares, they having, though in small amount, the entire capital stock. Though, as petitioners argue, it was their intention to receive notes for the money put out by them, it was also their intention to receive, and they did receive with the other stockholders in like position as to advancements, the entire issued capital stock of the corporation and all the control and value it entailed, in proportion to the money which went into the corporation."